29 July 2011

Secretariat
Committee on Payment and Settlement System
Bank for International Settlements
Sent by e-mail to cpss@bis.org

Secretariat
Technical Committee
International Organization of Securities Commissions
Sent by e-mail to fmi@iosco.org

Comments to consultative report 'Principles for financial market infrastructure" from Japan Securities Clearing Corporation (JSCC)

Dear Secretariats,

Japan Securities Clearing Corporation ("JSCC") was established in July 2002 as the first cross-market clearing organization in the Japanese securities market by Tokyo Stock Exchange, Osaka Securities Exchange, Nagoya Stock Exchange, Sapporo Securities Exchange, Fukuoka Stock Exchange and Japan Securities Dealers Association. In January 2003, JSCC was licensed as the first clearing organization in Japan to conduct the Financial Instruments Obligation Assumption business under the Financial Instruments and Exchange Law.

In 2011, JSCC reached its eight-year milestone. We take great pride in being one of the principal infrastructure providers to support increasingly diverse and sophisticated securities and derivatives transactions. Our endeavors for contribution to the enhancement of competitiveness and development of the Japanese financial and capital markets will never cease.

JSCC appreciates the opportunity to comment on the 'Principles for financial market infrastructure' proposed on March 2011 by Committee on the Payment and Settlement System and Technical Committee of the International Organization of Securities Commissions. As the cover note to the consultative report particularly requests, JSCC would like to comment on issues about stress testing (Principle 4, and 7), segregation and portability (Principle 14) and business risk (Principle 15) as follows.

1. Comments on Stress Testing（Principle 4 and 7）

With respect to the issue whether CCP's several kinds of financial resources/liquidity lines should cover credit/liquidity risk resulting from default of the largest one participant or the two largest participants, JSCC does not deny the possibility of multiple (simultaneous or sequential) participants' defaults, however, even if taking the fact that financial products and types of participants differ for each CCP into consideration, it would have to be said that probability of the largest two participants' simultaneous or sequential defaults is extremely low, and requiring CCPs to keep financial resources/liquidity lines in the amount which is calculated based on the assumption of the largest two participants' default means imposing more burden of establishing buffer on clearing participants, market and CCP itself comparing with the degree of the riskiness which each CCP fundamentally bears, and JSCC is highly concerned that it could noticeably inhibit market efficiency.

JSCC thinks that if CPSS-IOSCO is to establish such quantitative minimum requirement, it is believed to be practical to refer to the actual practices of stress testing which each CCP currently employs and if the possibility of multiple participants' default is taken account, so if the Principle includes simultaneous/sequential participant defaults as the minimum requirement, it would be appropriate to set "cover the largest one with its affiliates plus several financially weak participants (e.g. 5 least creditworthy participants)", which seems to be rather reasonable scenario in light of our past experiences.

In addition, in calculating the amount of financial resources/liquidity lines to be held by CCP, regardless of whether the minimum requirement is "cover one" or "cover two", what stress scenario should be employed is absolutely critical when conducting stress testing. It makes sence that stress scenarios refer the historically most volatile price fluctuation, because price development is out of control of CCPs. In contrast, many CCPs have certain degree of authorities to proactively constrain participants' positions when the risks they hold exceed given amounts (e.g. JSCC's business rules actually stipulate that JSCC has an authority to implement such proactive position risk control procedures). JSCC, therefore, thinks it is not appropriate to uniformly employ the historical peak of positions for stress scenario combining with the highest volatility. The positions for stress test should be set on the ground of CCP's current risk management framework and its power of constraining participants' position.

Therefore, with regards to the stress scenario which each CCP should employ when conducting stress testing, JSCC thinks it appropriate to leave some room for regulators/overseers in each jurisdiction to nail down adequate level of stress scenario taking such CCP's power of constraining position aggregation into account, and the wording in Principle 4 and 7 should be modified in accordance with that consideration.

２．Comments on Principle14（Segregation and Portability）

JSCC strongly agrees with CPSS-IOSCO's recognition that there may be a market structure and legal impediments to CCP facilitating segregation and portability in cash markets.

In contrast to derivatives products, the amount of funds and/or securities to be delivered or received pertaining to cash transaction (i.e. gain attached to or loss incurred by each party of cash transaction) is predefined, and generally, customer protection framework such as compensation from investor-protection fund, etc is provided for protecting customers' right to receive funds and/or securities as initial contract predefined even in the case of insolvency of a participant. Moreover, even for the investors who are not protected by such customer protection framework, an exchange-of value settlement system by which they can avoid principle risk is generally provided by relevant FMI as an alternative customer protection measure.

In addition, it should be noted that most of cash transaction is settled within a few days (～T+3) so it can hardly said that ensuring portability of customers' position in cash markets is a practical way to secure customers' interest.

JSCC thinks it better for FMI principles to clarify that securing customers' interests is the key element of Principle 14 and securing portability is not necessarily a prerequisite condition for cash products as long as customers' interest are secured by other measures in the relevant framework.

Therefore, JSCC would like to suggest that footnote 90 be amended as follows;

> *90 This principle generally covers all types of CCPs. However, in the case of some CCPs for cash markets, domestic law enables alternative measures other than segregation and portability for securing customers' interests ~~by alternative means~~. In these jurisdictions, the CCP and relevant authorities should evaluate the extent to which the CCP should revise its operations and adopt rules and procedures that enable them to secure customers' interest ~~segregation and portability~~ in conformity with this principle.*

3. Comments on Principle15（General business risk）

JSCC would like to point out the following two important aspects which might be overlooked when drafting specific minimum quantitative requirement.

(1) Since liquid net asset funded by CCP's own equity is one of the prime financial resources covering credit risk as well as liquidity risk, and we recognize that some CCP have actually committed to provide significant part of its own equity capital for covering such risks.

(2). With respect to structure of CCP's operating expenses, in common with ordinary corporations, operating expenses consists of direct cost and indirect cost, and even more specifically, it is believed that the cost which is necessary for conducting clearing business generally rises and falls proportionally to volume of cleared transaction, so it would appeared that increase in such cost is inextricably linked with boost in the operating revenue (i.e. clearing fee) which accompanies the increase in volume of cleared transaction .

On the other hand, since CPSS-IOSCO's proposal argues that FMI should maintain specific amount of liquid net assets funded by equity for ensuing orderly wind-down or reorganization, the proposal seems to be based on the assumption that CCP's direct cost stays constant but operating revenue disappears completely in wind-down or reorganization process.

Therefore, we think current proposal of simply requiring 'X months of operating expense is not based on the reality of operating expense structure.

In addition, while key consideration #2 and paragraph 3.15.6 propose that "*Resources held to cover potential general business losses should be in addition to resources held to cover participant defaults or other risks covered under financial resource principles",* JSCC is of the view that there is not necessarily an inherent causal relation between participant's default and occurrence of business risk, and requiring separate financial resources for different kinds of risks which are irrelevant to each other seems excessively conservative and undermines efficiency.

We are concerned that if such an impractical minimum requirement is established, it is envisaged that CCPs would have no other choice but transport their own equity capital, which in nature held for covering credit/liquidity risk, to the one covering 'X months of operating expense' requirement, and consequently, such CCP's reaction leads to undermine the stability of the market. Furthermore, CCPs might require clearing participants to post more collateral in order to cover the shortfall of financial resources resulting from such situation. It can hardly be said that such outcome is beneficial to whole financial market.

JSCC thinks it better not to prescribe such quantitative minimum requirement but to prescribe FMI's general responsibility to assess the qualitative and quantitative business risks. However, if CPSS-IOSCO prefers prescribe such quantitative minimum requirement as a proxy, we would like to suggest that the reality of operating expense structure be considered and key consideration 3 be amended as follows. Furthermore, in order to avoid the adverse effect mentioned in the previous paragraphs, such proxy should be as small as possible (i.e. Six months).

3. At a minimum, an FMI should hold equity capital at normal times equal to [six~~, nine, or twelve~~] months of the expenses which is indispensable to continue providing service taking in to account the envisioned scenario of orderly wind down/reorganization. An FMI may also need to hold additional equity capital, taking into account its general business risk profile. Capital held under international risk

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